

FARM BUSINESS MANAGEMENT



FARM CORPORATIONS

ATLANTIC COMMITTEE ON EXTENSION, ECONOMICS & EDUCATION

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FOREWORD

This publication is one of a series on Farm Business Management prepared by a sub-committee of the Atlantic Committee on Socio-Economic Services and published by authority of the Ministers of Agriculture of Nova Scotia, New Brunswick, Newfoundland and Prince Edward Island.

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INTRODUCTION

Traditionally, the typical family farm unit has been in the form of the sole proprietorship or perhaps a partnership between two or three farm owner operators; an independent decision making unit which combined the functions of ownership and management, and also to a large extent, much of the labor component. The same situation basically exists today, although to a slightly lesser extent as farm operations have become larger and more sophisticated in their production and business management techniques.

Incorporated farm operations have been in existence for many years, albeit making up only a small percentage of the total number of farm operations.

However, as farm operations become larger, more highly levered financially, have more principal operators and acquire more income earning potential, more farm operators will ponder the question, "should I incorporate my farm business?"

Although incorporation may still not offer sufficient benefits for most farm operations, obviously, there will be a certain sector of our farm units which may benefit from incorporation, whether it be a significant saving in income tax dollars or in implementing a better management structure.

The material in this publication is intended to provide farmers with some basic information regarding incorporation, specifically as it applies to farm operations. It is hoped that it will be useful supplementary reading for farmers prior to or during consultations with their Accountant, Lawyer and/or Farm Management Advisor.

INCORPORATION - THE BASICS

Incorporation represents a form of business arrangement which differs substantially from the other common forms of business organization, such as the sole proprietorship or the partnership. A corporation or, company * as it is commonly called, is a separate legal entity (an artificially created legal person) and is distinct from the persons who are its shareholders. Its assets and liabilities are its own and not of the shareholders. Its liability for indebtedness is limited to the assets which it owns and, subject to filing certain reports, it can exist forever. Also, as a legal entity, a company is subject to the same laws and can do many of the same things that an individual can do. It may own personal property, make contracts, sue or be sued, buy, hold and transfer property.

At the time of incorporation, the owners of the company (shareholders) are issued certificates which represent their share of stock. A share of stock represents a share of the total worth of the farm business. Therefore, when a farmer transfers his property, such as land, buildings, equipment, livestock, etc., into the company, it becomes the holder of the title to such property. The farmer then has title only to the allotted shares which he holds as his personal property.

Separation of ownership and management is a characteristic of the corporate farm. A sole proprietor owns his business and makes the management decisions. In a partnership, the partners are the owners and decision makers. In a corporation, the shareholders are the owners, but control is determined by virtue of the number of voting shares which an individual holds. Almost without exception, farm companies are private limited companies. The private company differs from the public company primarily by the following conditions:

- The right to transfer shares is restricted in some manner.
 - The number of shareholders is limited to fifty (50).
 - The company is prohibited from offering its securities to the public.
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* There is frequently confusion caused by the use of different terms as "company", "corporation", "limited company" and "company limited". These terms are used to describe the same legal entity which is a body corporate. In this publication the terms "company" and "corporation" are used interchangeably.

- The financial statements are private documents.
- In the Atlantic Provinces, a corporation may be set up with one (1) shareholder.

Each province has a statute under which a company may be incorporated. In addition there is a federal statute called the Canada Business Corporations Act under which a company may be incorporated. Your lawyer will advise you on the appropriate statute under which you should incorporate, although generally it will be the applicable statute in your province of residence. The procedures for incorporating a company vary from province to province and your lawyer will be familiar with the procedure in your province.

Although different provinces use different names for the main documents which regulate a company they invariably consist of the following types of documents:

Basic Constitutional Document: This document contains the basic constitution of the company which states the name, objects or restrictions on objects, and amount of authorized share capital. This document is sometimes called the Memorandum of Association or Articles of Incorporation.

By-Laws: These are sometimes called Articles of Association and are the working rules of the company and deal with its internal administration. They includes such items as:

- officers of the company;
- procedures for annual meetings and elections;
- voting procedures;
- sale, restrictions, and transfer of shares;
- procedures for handling accounting, dividends, reserves and audit.

Notice of Registered Office: Location of registered office must be filed with the government department in charge of incorporations.

Capital Structure

When a farm business is incorporated, a decision must be made as to the type and number of shares to be authorized and issued. In the Memorandum of Association, (Articles of Incorporation in some provinces), the principals will state the total share capital which is authorized. The number of shares actually issued by the company does not have to equal the amount authorized, but naturally, the amount issued cannot exceed the amount authorized. Most statutes now permit an unlimited number of shares to be authorized.

There are two general types of shares which are used by a corporation.

Common Shares are those which increase in value as the corporation itself increases in value. Their value is totally dependent upon the value of the assets, less the liabilities (net worth) of the company. Common shares may be issued with or without a par value, depending upon the requirements of the governing statute. Shares with a stated par value are those with a face value, for example, \$1.00 per share. This does not necessarily mean that the shares are worth \$1.00 each. If business assets appreciate and/or operations are profitable, the net worth of the company will increase and the common shares may be worth considerably more than the \$1.00 par value. The real value of the common shares then, should directly reflect the net worth of the company.

Preferred Shares are those which generally will not increase in value with the growth of the company, however they do possess certain other advantages. Dividends are paid on common shares only when the directors declare dividends either from current or past profits, whereas holders of preferred shares receive dividends according to the terms of those shares. For example, the owner of a \$1,000., 8 percent preferred share may receive up to \$80. per year in dividends if there is insufficient profit to divide up and if the directors decide to declare a dividend. Thus, preferred shares receive a priority position over common shares with regards to dividend payments or distribution of assets in case of bankruptcy. The common shares would receive a residual value after all other claims were satisfied.

Preferred shares may be classified as cumulative or non-cumulative. This means that if a company is unable to pay the dividends on cumulative preferred shares in a given year, the dividends are accumulated and paid out when the company is able to do so in subsequent years.

Preferred shares can be further characterized as redeemable and/or retractable. Making a preferred share redeemable means that the company has the ability to repurchase the share from the holder at its option for a fixed sum. The company would simply tender to the shareholder the appropriate amount per share, plus any dividend which might be owing and the shareholder would be required to sell some or all of his preferred shares.

Adding a retractable option provides the same option to the shareholder as the redeemable characteristic gives to the company. The shareholder is given the ability to request that the company repurchase the shares for a fixed sum, plus any dividends which might be owing on the shares in question. The company would, provided it was financially able, be required to purchase these shares at the same amount as the shareholder would receive in a share redemption.

Both Common and Preferred Shares are further designated as voting or non-voting. The proportion of voting shares held by the shareholders will determine who has control of the farm business.

To ensure control of management, the principal owner, e.g. the father, usually holds the majority of the voting shares (minimum 50% + 1 shares) until such time as is deemed suitable to transfer this power to other family members.*

Why Different Types of Shares?

The simplest share structure for a farm company would involve a single class of common shares. However, depending on the circumstances, there may be definite advantages in issuing both common and preferred shares and possibly different classes of each type of share.

* Whether or not it is possible for minors to independently hold shares in a corporation will depend upon the governing statute where minors are permitted to hold shares. They may not be able to exercise the normal powers of shareholders (such as voting) until they reach the legal age of consent. Until such time these shares are frequently held by a trustee and these powers may be exercised by the trustee. Increases in share value and dividends will accrue to the child but may be taxable to the parent.

One useful application is in estate planning and farm transfers. In practice, a parent's estate is frozen at a specified value through the issuance of preferred shares which remain at a fixed value. Any growth in the business would then go to the common shares. These can be held, primarily by the children to ease the transfer of the farm to the next generation.

Different classes of shares make it easier to allocate income. For example, the directors will be in a position to declare dividends on the preferred shares held by the parents which can vary from the dividends paid on the common shares which may be held by the children.

It is generally advisable to authorize both voting and non-voting shares. This allows greater flexibility in that the principal operator (parent) can transfer more equity to his children in the form of non-voting shares without losing control of the company. When the time is right, then the voting shares may also be transferred. Remember that both common and preferred shares may have voting or non-voting characteristics.

Always keep in mind that the creation of a share structure is dependent on your present and future needs. Be prepared to discuss your goals and plans with your accountant and lawyer so that an appropriate share structure can be created to accommodate these goals and plans.

Shareholders' Loans

It is possible to form a corporation through the issuance of shares only, but in most instances non-share consideration in the form of shareholders' loans to the Corporation is advisable where income tax laws will permit without causing tax problems. Such loans may, but need not, be subject to an interest rate. The combination of shares and promissory notes may hold certain advantages over the receipt of shares only. For example:

- Loans may have an income tax advantage to the company and to the holder of the note. The repayment of the principal is not considered income to the lender. This may be very important in putting assets into a company on a tax free basis pursuant to Section 85 of the Income Tax Act.
- Dividends paid on shares are not a deductible expense to the company, whereas with a promissory note any interest paid pursuant to the terms of the promissory note may be deducted. In summary, the recipient will be faced with a tax liability for the interest received but not on the principal payments.

- Installment payments, unlike dividends on shares, are not dependent upon profits before they can be legally paid out. As a result, they provide a more reliable cash flow for the farmer. This is especially important for parents during retirement.
- The farmer would not have to sacrifice any part of his voting control as might be the case if he had received voting shares (either preferred or common) and later had to sell or have the company redeem the shares to provide cash.

Transfer of Assets to the Corporation

When a farm business is incorporated and farm assets are transferred to the company, a sale of these assets is deemed to have taken place. If these transfers are deemed to take place at fair market value, they will attract taxable capital gains on items such as land and buildings, recaptured depreciation on buildings and equipment, and income on inventory items such as livestock, crops and supplies, and on farm quotas. This situation can result in a considerable income tax liability to the owner of these assets.

However, a section in the Income Tax Act (Section 85) makes provision for a taxpayer or, in this case, a farmer, to transfer or "roll-over" assets into a corporation without taxes being payable if the farm business liabilities do not exceed the tax cost of the transferred assets and if the proper formalities are followed. The property being transferred must be recorded in on a special election form (no. T2057), provided by Revenue Canada. This form allows the sale price of the property being transferred to be selected by the farmer and the company and describes the type, value and number of shares issued in consideration for the sale. The amount elected becomes the proceeds to the farmer transferring the property and also the cost of the property to the corporation.

The election form T2057 should be filed with Revenue Canada by one of the parties within the prescribed time limit which is generally before the first tax returns are filed for the corporation. Failure to do this, may result in substantial financial penalties assessed by Revenue Canada. The form is highly technical and should be prepared and filed by your professional advisor. Under Section 85, assets must be transferred at a value no less than their tax cost and not greater than their fair market value.

If we assume that the objective of the transfer is to result in the corporation obtaining high a value as possible for tax purposes of the adjusted cost base to the corporation, without generating any tax payable to the transferor, then the following guidelines may be followed:

<u>Asset</u>	<u>Elected Value of Transfer</u>
Land	Adjusted cost base* (V-Day Value); (or possibly fair market value to take advantage of Capital Gains Exemption)
Assets on Part XVII (straight line Capital Cost Allowance)	Current fair market value
Assets on Part XI (diminishing balance Capital Cost Allowance)	Undepreciated capital cost
**Quotas (acquired pre 1972) (acquired after 1971)	V-Day Value Eligible capital amount
Basic Herds	V-Day Value
Inventory	\$1.00 (or possibly a higher amount in order to absorb previous business losses of the Transferor)

There are several restrictions related to the transfer of assets into a company under Section 85. Section 85 does not allow the "roll-over" of accounts receivable. Also, restrictions in the Act do not allow "basic herds" to be rolled over, rather the herd is deemed to be sold at the V-Day value minus any exemptions used, up to the date of transfer and the corporation receives this at this cost, which it may treat as an expense.

Inventory, such as livestock, crops and supplies, are permitted to be rolled over into the corporation at elected value. The elected value for such inventory may be as little as the tax cost of the inventory to the transferor but not less than \$1.00. The tax cost of inventory in most situations, is considered as nil.

* Adjusted cost base: original cost plus non-deductible capital expenditures; this would apply mainly to land purchased after Valuation Day, Corporate shares or a Partnership interest.

** The Income Tax Act now provides that quotas may constitute qualified farm property in certain circumstances and, as such, would be eligible for the \$500,000 individual capital gains exemption. This fact may have some influence on the transfer value of quotas into the corporation.

There may be reasons why assets should be rolled into the company under Section 85 at values higher than those previously mentioned. For example, inventory items may be transferred at values greater than zero to absorb previous farm losses of the transferor. The resulting transfer value may then be expensed by the corporation when it pays the farmer for the inventory. Capital assets, such as land, might be rolled into the company at fair market value to take advantage of the current Capital Gains Exemption Legislation. Any resulting capital gains may be offset by this exemption on qualified farm property up to a maximum of \$500,000. per individual.

Transfer all Farming Assets into the Corporation?

In most cases, when a farming business is incorporated, all or nearly all of the farming assets are transferred into the newly-formed company. Any Income Tax Liability can be avoided in most, but not all circumstances by making an election under Section 85 of the Income Tax Act. Tax liability cannot be avoided where the farm liabilities are greater than the tax cost of the transferred assets.

However, some consideration should be given to keeping certain assets out of the company, that is, the retention of ownership by the individual shareholder. For example, in a livestock operation, the livestock, and equipment could be rolled into the company under Section 85 (ITA). The real estate, e.g. land, buildings, and quota could be retained by the parent(s) and leased to the company. Similarly, if real estate is owned by other farm family members, private ownership could be retained and the property in question leased to the company for a reasonable fee.

The main advantage in doing this is greater flexibility. A farm operator is then not merely just a shareholder, but retains control of specific property, which may give him more options, if the need and situation arises. The rental fee received for his personally held assets is another source of income.

If the farmer wishes to sell out (retire) he can gift his shares in the company to his children. The company itself can then borrow long term funds and buy the real estate from the parent, thus avoiding a potential problem of children personally borrowing funds to buy the shares, an issue which will be discussed in more detail further on in this publication.

The capital gains exemption on qualified farm property will apply on the sale of land and buildings by the parent(s). Recaptured capital cost allowance could be a problem with buildings under Part XI capital cost allowance. On the other hand, some older buildings may still be on Part XVII C.C.A. (straight-line depreciation) if they have never been transferred into the corporation, hence there would be no recaptured capital cost allowance upon transfer of any straight-line assets.

The action taken in incorporating the farm may affect the farmers entitlement to the capital gains exemption for qualified farm property and therefore the transfer must be carefully planned by the farmer's tax advisors to maximize the use of the exemption at the time of incorporation and in the future.

Insurance Coverage

Care must always be taken to ensure that all insurance on farm assets and liability insurance is reviewed and changed as necessary when the assets are transferred to a company to reflect the new ownership of the assets and the new liability of the company and its employees. This matter should be discussed with your lawyer and insurance agent.

ADVANTAGES OF INCORPORATION

Potential Income Tax Savings

In recent years, the primary reason for incorporating has been the possible savings in Income Tax Payable when profits from the operation reach a sufficiently high level. Actually, deferment of taxes might be a better word because, no savings are realized if the profits of the company are ultimately removed by the shareholders in the form of dividends.

The corporation differs from both the sole proprietorship and the partnership in that it pays income tax on its earnings, whereas in the other forms of organization, the income is claimed entirely by the sole proprietor or partners and taxed at prevailing rates for individuals.

In addition, the shareholders in a company must pay taxes on any dividends which they receive from the corporation.

Farm corporations, in nearly all cases, qualify as Canadian-controlled private corporations, and as such, are eligible for the small business taxation rate.

The 1988 general taxation rate for corporations is 38 percent. However, most family farm corporations are eligible for the small business taxation rate. The small business rate applies to the first \$200,000 of active business income per year. Any corporate income above this amount will be taxed at the regular corporate rate.

Corporate Income Tax Rates

*Proposed small business rates effective July 1, 1988.

	<u>N.S.</u>	<u>N.B.</u>	<u>P.E.I.</u>	<u>Nfld.</u>
Federal rates (%)	12.0	12.0	12.0	12.0
Provincial rates	10.0	9.0	10.0	12.0
Federal surtax at 3%	<u>.4</u>	<u>.4</u>	<u>.4</u>	<u>.4</u>
Total small business	22.4	21.4	22.4	24.4

corporate rate*

* On active business income only. The 1988 combined rate is 38% on all other types of income except dividends from taxable Canadian corporations.

Splitting of Farm Income

After the operator, and possibly his spouse, have drawn a salary from the company, any profits which may remain in the company, up to the annual maximum of \$200,000, will be taxed at the current small business rate as indicated above. The individual's marginal tax rate increases quite sharply after his taxable income reaches a certain point as indicated in the following 1988 rates.

Provincial Tax rates expressed as a percent of Federal Tax Payable:

	<u>%</u>
Nova Scotia	56.5
New Brunswick	60.0
Newfoundland	60.0
Prince Edward Island	56.0

Federal, Provincial and combined rates of taxation for Individuals expressed as a percentage of Taxable Income.

<u>Taxable Income</u>	<u>Federal %</u>	<u>N.S. %</u>	<u>N.S. Combined Rate %</u>	<u>N.B. & NFLD %</u>	<u>N.B. & NFLD Combined Rate</u>	<u>P.E.I. %</u>	<u>P.E.I. Combined Rate</u>
\$0-27,500	17	9.6	26.6	10.2	27.2	9.5	26.5
\$27,501-55,000	26	14.7	40.7	15.6	41.6	14.6	40.6
\$55,001 & over	29	16.4	45.4	17.4	46.4	16.2	45.2

From this table we can see that, even at the lowest level of individual tax rates, the small business tax rate is lower and is certainly substantially lower at the higher individual rates. Therefore, there is an income tax advantage in leaving profits (retained earnings) in the company rather than drawing them out by way of salaries and/or dividends. On the other hand, there is no tax advantage to incorporation if all of the profits of the business are required for personal use. Even if some of the profits are withdrawn in the form of dividends, the tax structure is such that the resulting combined tax liability is substantially the same as if the profits were earned entirely as a sole proprietor.

The following example demonstrates that an individual's net after-tax cash earnings remain virtually the same, whether he is a proprietor or an employee of his own company, if all profits are withdrawn from the company.

Assume: Individual (A) is in the highest income tax bracket so that additional income is taxed at the highest rate.

	<u>A</u> <u>Individual</u>	<u>B</u> <u>Ltd.</u>
Earnings of Business	<u>\$10,000</u>	<u>\$10,000</u>
Corporate tax @ 22% (N.S.)		<u>2,200</u>
After-tax corporate profits		7,800
Dividends paid out of company		<u>7,800</u>
Cash remaining in company		0
Individual earnings before tax	10,000	7,800
Personal income tax	<u>4,540</u>	<u>2,391*</u>
Net cash received by individual	<u>5,460</u>	<u>5,410</u>

* Amount of dividends received by individual	\$7,800
Taxable amount of dividends received (grossed up up by 25%)	9,750
Federal tax payable at 29%	2,828
Less dividend tax credit (16 2/3% of actual dividend received)	<u>1,300</u>
Net Federal tax payable	\$1,528
Provincial tax payable @ 56.5%	<u>863</u>
Total income tax payable	<u>\$2,391</u>

**Possible Income Tax Savings Due to Incorporation at Various
Levels of Farm Net Income (1988 Rates)***

Assume:

Operators Salary - \$20,000

Personal Tax Credits - \$2,200

Unincorporated

Farm Net Income	20,000	40,000	60,000	80,000	100,000
Total Tax Payable	1,878	8,960	17,332	26,409	35,486

Incorporated

Operators Salary	20,000	20,000	20,000	20,000	20,000
Income Tax Payable	1,878	1,878	1,878	1,878	1,878
Corporate Profit	0	20,000	40,000	60,000	80,000
Income Tax Payable @ 22%	0	4,400	8,800	13,200	17,600
Total Income Tax Payable	1,878	6,278	10,678	15,078	19,478

Potential Savings
(Deferral) Due

To Incorporation	0	2,682	6,654	11,331	16,008
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It is evident from this table that appreciable income tax savings due to incorporation do not occur until net farm income exceeds \$40,000 (per principal operator) annually.

Another important factor to consider is the amount of Business Investment Tax Credit available. If, for example, the operation is in an expansion mode and is making a lot of investment in new buildings and equipment, there can be a lot of investment tax credit available to reduce Federal Income Tax Payable of the operator(s). If the business is incorporated and if the corporation purchases the assets, then the Investment Tax Credit will not be available to the shareholder to reduce his personal income tax. On the other hand, the corporation, may not have sufficient retained profits in order to utilize the available tax credits in which case, a considerable potential benefit may be lost. Therefore, the amount of available Investment Tax Credit may significantly affect the net income level at which Incorporation becomes feasible.

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- * (i) Nova Scotia rates
 - (ii) for purposes of simplicity, items such as Federal Surtax, Federal Sales Tax Credit, etc. were not included in calculations

Transfer of Ownership

When a farming operation is incorporated, the ownership of land, buildings, equipment, livestock and other assets is converted into common and/or preferred shares and shareholder loans. If, for example, a parent wishes to transfer some equity in the farm to members of his family, he may gift or sell some shares to them. This is more convenient than transferring part of the land, livestock and equipment.

If the father or some other shareholders should die, the business is not required to dissolve. Instead, the shares become part of the estate. They can be willed to the shareholder's heirs or they may be bought by the other shareholders.

A gradual sale of shares permits the parents to develop a retirement fund while allowing the younger shareholders to increase their share of the business. Shares may be transferred to a new shareholder by handing them over to the person and recording the transfer in the appropriate company books. The tax aspects of any such transfer must always be considered. The ease of transferring shares makes a progressive shift in management possible. Management control arrangements are very flexible as 50 percent plus 1 of the voting shares give control for most purposes. More refined arrangements are possible. There can be voting and non-voting stock to give special rights to the shareholders. Assets may be exchanged for notes to make a person a creditor rather than an owner subject to income tax considerations. Arrangements such as the foregoing are very useful in keeping control in capable hands.

Parent-Child Rollover

Income Tax Legislation allows the tax deferral transfer (roll-over) of shares in a family farm corporation from a parent to a child if substantially all of the assets of the corporation are used in the business of farming and any one of the children or parents are actively engaged in the farm business carried on by the company. This transfer can be either upon death via a will or while the farmer is still alive (i.e. inter vivos). For a roll-over to apply, the child who is receiving the shares must be a resident in Canada immediately before the transfer takes place. Specific rules concerning the parent-child rollover are outlined as follows:

Family Farm Corporation - to qualify, the corporation must be a Canadian controlled private company. The main requirement is that the corporation has at least one or more shareholders with 50 percent control living in Canada.

This rarely poses a problem except if the parents retire outside Canada. For instance, if the parents decide to live in Florida for the better part of the year, they may lose their right to the roll-over provision. It is very important to consult with an accountant and/or lawyer before you decide to retire in another country.

Substantially all of the assets - What determines "substantially" has not been clearly defined. However, Revenue Canada has generally considered that it means at least 90% of the fair market value of all assets of the corporation. It is advisable that any major off-farm investment be held in the name of the shareholders and not the company. A second investment company should be considered if these holdings are significant.

Any one of the parents or children actively engaged - Two common misconceptions concerning the roll-over position are that the father and son must both farm the land and that the roll-over of shares can only be to the children actively farming. Both are in error.

Only one family member needs to farm the land. It can be father, mother or child. If only one child farms the land, company shares can still be transferred from the parent to nonfarming children free of tax. The definition of child includes: grandchild, great-grandchild, daughters and sons-in-law, adopted children, and as recently proposed for amendment, dependent individuals under the age of 21.

Must be resident in Canada before the transfer - If you were to transfer any shares to any children while they were living outside Canada, tax officials would deem the transaction to take place at fair market value. Regardless of the actual transfer price, you could be faced with potential capital gains. Your individual capital gains exemption on qualified farm property would potentially still apply however.

Capital Gains Exemption - Qualified Farm Property

The capital gains exemption was introduced into the Income Tax Act in 1985. The original exemption allowed a taxpayer to realize up to a total of \$500,000. capital gain on the sale of qualified farm property without being subject to tax on the capital gain (see "Alternative Minimum Tax" below.) The capital gains exemption for other property was to eventually increase to \$500,000. over time. However, in total, no taxpayer would be able to use more than \$500,000. in exemption.

The 1987 tax reform proposals have changed the capital gains exemption rules. These rules are fairly complicated and the following discussion is intended to be general in nature. Careful planning with a qualified tax advisor is essential before relying upon these rules.

Under the current law which implements the tax reform proposals, the \$500,000. exemption remains available for qualified farm property and has been extended to shares of certain types of non-farm companies. The general capital gains exemption has been capped at \$100,000. and will not increase. The maximum capital gains exemption to which any taxpayer is entitled is \$500,000. and therefore a farmer, for example, who uses the \$100,000. general capital gains exemption can only use \$400,000. for qualified farm property. The taxable portion of a capital gain (that is the portion which is included in income and subject to tax) is $\frac{2}{3}$ in 1989 and increases to $\frac{3}{4}$ in 1990 and future years. The gain to which the capital gains exemption applies is effectively the full gain and not the taxable portion only.

"Qualified farm property" for which the \$500,000. exemption applies consists of:

- a. shares of a family farm corporation,
- b. partnership interests in a family farm partnership,
- c. land and building used in a farming business,
- d. quotas used in a farming business.

Each of these terms is qualified by technical rules. For example the land, building and quota must be used in a farming business by certain people for a particular number of years and the taxpayer must have earned a certain portion of this total income from the business in particular years. The total gain on the sale of buildings and quotas will not qualify. It is only the gain above and beyond the original cost or December 31, 1971 value which is available for the exemption.

Alternative Minimum Tax - It must always be remembered that even though a capital gain may be exempt it can nevertheless result in the taxpayer being required to pay a special tax called the Alternative Minimum Tax. If this special tax applies it may serve to reduce taxes for future years and therefore may not be totally lost.

Planning Opportunities

The combination of the capital gains exemption and the parent to child special rollover rules for farm properties (inter-generational transfer rules) provide a unique opportunity for farms to do tax planning on the sale of the farm. For example, if shares of a farm corporation cost a farmer \$1.00 and are worth \$600,000. then the farmer can sell the shares to a child for \$500,000. and use the \$500,000. capital gains exemption. (Any other taxpayer would be required to sell the shares for \$600,000.)

The \$500,000. would provide the farmer with a retirement nest egg and could be collected from the child as needed in future years and whatever was not required during life could be given to the child by the farmer's Will. Similar planning could apply on the sale of farm real estate and quotas.

It is very important to consider the qualified farm property capital gains exemption rules at the time of incorporation because they provide unique opportunities for tax planning.

Farm Business Continuity

A company can exist for as long as the shareholders wish to keep it operating and it continues to meet the requirements of the statutes. In theory, it provides a means of keeping the farm business operating and avoids many of the problems that arise on the death of a sole proprietor. In actual practice, the loss of the principal shareholder may have a serious impact on the continued operation of the farm business. A one-man farm company or a farm company with no definite plans for handing the reins over to a capable manager has no real permanence.

Some farm companies insure the lives of major shareholders to assure the financial continuation of the business. The proceeds are used to assist the company over the period following the death of the manager or to underwrite a share-purchase plan which would take effect on his death. Professional advice should be obtained on whether life insurance should be payable to the company of a surviving shareholder or spouse. Important tax issues are involved in this decision.

Management

Management sometimes improves as a result of incorporation, although the mere act of incorporation will not bring about such results automatically. However, a more regulated structure with better accounting procedures, and the delegation of managerial duties may promote a more business-like atmosphere which may lead to a more efficient farm operation.

Limited Liability

For shareholders, a possible advantage of incorporation is limited liability. If a limited liability company fails, the creditors cannot seize the personal or real property of the shareholders. The liability of the shareholder is limited to the amount he has paid or agreed to subscribe for a purchase of shares in the company.

However, in many cases when a family farm is incorporated, most or all of the assets must be transferred to the company in order that it is adequately capitalized. In this case, all of the assets would be represented by shares in the company and placed at the full risk of the business.

If the farmer transferred only part of his assets to the company and took the balance as notes payable, the company might be inadequately capitalized because of liabilities in the form of notes payable and insufficient assets to cover them. The shareholder would become, in effect, a creditor of the company. Lending institutions usually require the principal shareholders to personally guarantee repayment of the company's debts so that most of the so-called advantages of limited liability would be wiped out.

Limited liability may be advantageous to the retiring farmer who wants to keep only part of his assets invested in the farm business. His other property would be protected and remain free from liability from the acts of operating shareholders.

Active farm operators who have considerable outside investments may find the limited liability aspect advantageous. Even if such persons transferred considerable assets to the company, all outside interests would be protected from any acts of the company provided he has not given a personal guarantee of the company's debts. As well as creditor liability, liabilities from law suits can also jeopardize the farm business. Assume, for example, that a company employee on farm business is

found negligent in a school bus accident in which a number of children are seriously injured. The employee and employing company could be sued for an enormous sum. In this situation, shareholder assets held outside the company would be protected from the lawsuit. On the other hand, a company is not liable for the personal debts and obligations of its shareholders. This can be a distinct advantage over other forms of business arrangements. It is evident, however, that the limited liability feature may be somewhat overrated and farmers should examine their situation very carefully if incorporation is sought for this reason alone.

Management Control

This aspect is more clearly defined in a company than in other arrangements such as partnerships. Simply stated, management control of the company can usually be achieved by holding a simple majority of the number of voting shares of the company, e.g. 51% or 50% plus 1 share. This aspect can be very important to a parent or parents who wish to involve their children in the ownership of the company, but also to reserve the right to make the final decisions on management issues until such time as they feel ready to pass on this responsibility. At such time, management control can be transferred by simply gifting or selling the appropriate number of voting shares.

Rollovers

As outlined in a previous section, the taxpayers may be entitled to a tax-free roll-over with respect to capital assets transferred to the corporation to the extent that the taxpayer receives shares of the corporation in exchange and the transfer is properly documented and reported for income tax purposes. This, in effect, means that the tax on capital gains can be deferred for one generation or more.

DISADVANTAGES OF INCORPORATION

Net Income Levels

There will be no income tax advantage and quite possibly a significant tax disadvantage if net farm income is low or the business is losing money. In a low net income or loss situation, the proprietor or partner will pay little or no income tax. However, if the business is incorporated, the company itself may not pay any income tax, but any funds which the shareholder operator draws out of the company for personal needs is treated as salary and/or dividends and taxed accordingly at prevailing personal rates. Hence, at a time when the operation may be under financial difficulties, the situation may be further aggravated by paying out more dollars to Revenue Canada. The farmer will also have to bear the higher administration costs inherent with a corporation.

Furthermore, a partner or proprietor may be able to deduct farm losses from other sources of income such as income from employment in certain circumstances. At the time of publication, these rules have been recently revised and further revisions are being considered by the federal government. The ability to do this is important to many farmers, particularly those who are attempting to get established in farming. Earnings from off-farm employment may be vital, and in many cases the refund of tax dollars realized from applying farm losses to other income is often crucial to the success or failure of the developing operation. Corporate losses cannot be deducted from other sources of income of the shareholder and effectively prevents the use of these tax dollars in the operation when they may be needed the most.

Complications in Ownership Transfer

Sale of the Farm

When an incorporated farm business is sold, it is advantageous, tax wise to the seller, to sell the shares of the company rather than the individual farm assets. The sale of shares will attract taxable capital gains only, which are eligible under the individual capital gains exemption for qualified farm property. The sale of individual farm assets out of the corporation will attract a tax liability on inventory items, recaptured depreciation on equipment, buildings, and quota, and taxable capital gains on land and buildings. In addition, a corporation is not eligible for the capital gains exemption on qualified farm property.

The buyer, however, in such a situation, faces certain disadvantages, primarily because of the fact that if a corporation buys back its own shares, the seller is treated as receiving a dividend instead of a capital gain. Otherwise, the buyer must buy the shares personally, and personally borrow any required funds. The buyer then, having assumed the liability for the share purchase, must personally make repayments of principal and interest on the loan. To do so, he must obtain funds from the company in the form of wages and/or dividends which are taxable in his hands. The interest portion of the loan payment is an offsetting deduction for this withdrawal, but the principal portion is not. Initially, this may not be significant, but as the years go by and the principal portion increases, it becomes increasingly more significant. In actual practice, the buyer, in most cases, would form a new company which would borrow the money and buy out the shares of the old (seller's) company. The two companies could then be amalgamated with the new company holding the loan. This would eliminate the problem of personally assuming and servicing the loan for the share purchase. However, the procedure has certain other income tax disadvantages to the buyer.

Other possible disadvantages for a prospective buyer in buying the shares of a farm corporation are outlined as follows:

- (a) The buyer may not wish to conduct the business under a corporate form of organization, particularly if he has other sources of income and expects some initial losses from the operation which he hopes to deduct from his other income for Income Tax purposes.
- (b) When individual farm assets are purchased at fair market value, there is usually a "bump up" or increase in the tax cost to the buyer. This results in a higher cost base for capital cost allowance purposes which translates into a saving of tax dollars for the buyer.

If the buyer buys shares, no "bump up" or increase of asset values is possible, hence less expense allowable for income tax purposes, particularly where the previous owner has written down the assets to a low level for income tax purposes.

Principal Residence

If the principal residence (farm home plus 1 acre of land) is transferred to the company, any capital gain will be taxable when it is ultimately sold. If the title to the home is retained by the farmers, any capital gain on the principal residence is exempt from taxation. Alternatively, a special farm option would

allow a \$1,000 basic deduction, plus \$1,000 for each year after 1971 that the property was his principal residence. This exemption would apply only to farm property that was not in the farm company.

One might argue that the capital gains exemption on qualified farm property makes this provision unimportant. However, in the case where an individual has used up all of his exemption, the personal residence exemption becomes significant. A subdivision of the residence lot may be necessary under land use by-laws.

Taxable Benefits on Company Owned, Personal-Use Assets

If the farming business is incorporated, the shareholder/operators should exercise care in the transfer or purchase of personal use assets, such as cars and personal residences.

If the corporation owns such assets, then the shareholders are deemed to "enjoy" a taxable benefit which is taxable in the hands of the shareholder, in addition to salary and dividends.

In the case of a residence owned by the corporation, it may claim certain expenses for income tax purposes. However, a deemed rental figure will be levied on the shareholder which can be a considerable amount, e.g. \$600-\$700/month, which must be claimed as income by the shareholder.

In the case of a vehicle, which is available for personal use by the shareholder the taxable benefit to the user depends upon a number of factors including the purchase price of the vehicle. This amount is taxable income to the recipient of the benefit.

In light of the preceding paragraphs, it would appear desirable, if possible, to leave personal assets such as residences and vehicles out of the corporation, both from the standpoint of taxable benefits accruing to the shareholders and the capital gain exempt status on a personal residence if ownership is retained by the shareholder.

In addition, if the company were to fail, the limited liability aspect may ensure that the operator would not also lose his residence and personal vehicles.

High Cost of Incorporation

The largest expense incurred will be the services of the professional experts, the lawyer and the accountant. There is a good deal of necessary legal work involved in making up share forms, notes payable, minutes of shareholder's meetings, articles and memorandums of association and so on. The services of a knowledgeable accountant are vital to ensure that the books of a company are properly set up and the relevant tax consequences are considered. The cost of incorporation is roughly \$1,000 and up. It will usually cost a good deal more than \$1,000.

High Cost of Dissolution

A corporation is much more difficult and expensive to dissolve if dissolution ever becomes desirable. When the corporation is formed the various farm assets can be rolled in under section 85 of the Income Tax Act which effectively circumvents the potential tax liability. However, no similar legislation exists when assets are transferred out of a company. Assets must transfer out at current market value; hence a potential heavy tax liability may exist in the form of recaptured depreciation, capital gains and the disposition of cash basis inventory as well as dividend income being received by the shareholder.

More Red Tape Involved

The companies Legislation in each province requires that certain reports be filed annually with the companies branch. A failure to comply with these requirements, may result in having the charter of the company revoked.

STEPS IN INCORPORATING THE FAMILY FARM

Become as knowledgeable as possible about the act of incorporation and specifically as it relates to farming enterprises.

Obtain literature on the subject from:

- Dept. of Agriculture publications;
- farm publications;
- Provincial Companies Act.

Discuss the subject with:

- your Farm Business Management Advisor;
- your Accountant and Lawyer;
- farmers who have incorporated.

Obtain competent, professional services. This cannot be overemphasized. Choose an accountant and lawyer who are not only well-versed in the act and procedures of incorporation, but who are familiar with Farm Income Tax Legislation. If possible, use local firms as they will be more readily available and responsive to your needs.

Avoid, do-it-yourself schemes and be wary of anyone offering incorporation for a cut rate. If you follow this route, there is a good chance that you will encounter legal and tax problems because of the improper formation of the company and share structure. Some firms may not explore individual situations sufficiently as to whether the farm business should or should not, in fact, be incorporated.

When competent professional services have been engaged, it is vitally important for good, three-way communication to be present between you, your accountant and your lawyer. Have all necessary information readily available and be prepared to answer any questions they may have. In turn, make a point of understanding what your accountant and lawyer are doing and insist on clear explanations as to how the new company is to be structured.

Get an estimate of the fees and disbursement costs for incorporating your business.

Your accountant should determine the various ways of allocating corporate income, paying particular attention to salaries, rents and other deductible items.

Once the accountant has determined the tax aspects and income allocations, he and your lawyer will jointly draft the actual documents of Incorporation such as the Articles of Incorporation or Memorandum of Association and the By-Laws or Articles of Association.

The appropriate forms are then completed and submitted to the appropriate government authorities.

Your accountant will be responsible for preparing any necessary opening balance sheets for the corporation and also for making any necessary elections with Revenue Canada. There is usually an election under Section 85 of the Income Tax Act, whereby the various farm assets are transferred into the corporation at selected values.

BACKGROUND INFORMATION REQUIRED BY YOUR ACCOUNTANT AND LAWYER

In order to obtain sound advice from your accountant and lawyer, some prior organization and assembly of facts is advisable. The following checklist contains the items that most professional advisers find helpful:

- 1) A sketch or photograph of the physical layout of the farm showing the different parcels of land, location of buildings and the farm home will help your adviser obtain a mental picture of your farm.
- 2) A summary of the fair market value of all your farming assets on hand at the present time is essential. An independent appraiser is not necessary, but if a dispute arises with Revenue Canada, verification of your figures by an accredited appraiser may be necessary. In addition, a complete breakdown of all your liabilities must be provided.
- 3) If the farm was owned prior to December 31, 1971, then it is also necessary to have a complete listing of all the farm assets owned at that time, together with their original cost and an estimate of their fair market value as of December 31, 1971 and at the present time.
- 4) For your adviser to assess your financial situation, personal tax returns and farm financial statements for as many previous years as you have them on hand would be useful. Budget projections for the current and future years would also be important.
- 5) Two companies cannot have the same registered name, therefore it is advisable to choose more than one name in the event, a name is already in use. If the name you choose is available, your lawyer will then reserve the use of that name for a period of time until the corporation is established. If the name you choose is not available, another name can be searched for until a satisfactory name is found.
- 6) You should have a summary of your personal and financial goals, as well as those of the other family members.
- 7) The decision of how ownership and control of the company is to be arranged is perhaps the most difficult task. Your advisors will outline the different share structures available but you will have to decide the type and number of shares to be issued and to whom.
- 8) Choice of a fiscal year: This is a chance to change the fiscal year of your business if desired and possibly defer some income tax payable.

Other key items include the monthly cash flow requirements to meet living costs, your estate plans as to the future distribution of your assets, and your retirement plans. This information is vital if your accountant and lawyer are to properly structure the corporation and help plan future financial and tax strategies.

NECESSARY OPERATING PROCEDURES

Set up an adequate double-entry accounting system. A corporation will require a system no more complicated than that used in a partnership or sole proprietorship. It is not mandatory, but probably advisable that you have an accountant prepare the year-end financial statements and Income Tax return. Taxable income may presently be reported on a cash basis. However, some modifications have been implemented by Revenue Canada to this system of reporting income.

A Federal T-2 Income Tax return must be filed annually rather than the T-1 general return used by sole proprietors and partners. Tax returns for a corporation can be filed up to six months after the end of its fiscal year. It will still be necessary for you to file a personal tax return for your salary, wages and dividends received from the corporation as well as other sources of personal income.

Business Investment Tax Credit is available to apply against Corporate Federal Tax; based on eligible capital purchases made during its fiscal year.

Livestock Inventory Provision under Section 28 ITC is available to farm corporations using the cash method of tax reporting and the new mandatory inventory adjustment under that section also applies to corporations.

Five year block average is not available to the farm corporation; a provision that is being phased out anyhow.

A private corporation is required by law to hold a statutory meeting within four months of incorporation, plus a minimum of one directors' meeting annually, complete with a set of written minutes which are to be entered in a minute book and kept at the corporation's registered office.

Annual reports must be filed with the government authorities and your lawyer will advise you on these. These reports do not include financial statements. In addition, other periodic notices of changes in the corporation may be required.

A failure to comply with any of the regulations may result in penalties, fines or even a revoking of the corporation's charter.

SHOULD YOU INCORPORATE YOUR FARM BUSINESS?

Obviously there is no clear cut or simple answer to this question. Each farming operation has a unique set of characteristics and must be considered strictly on an individual basis. For the majority of farming operations, incorporation probably would not be advisable as the disadvantages would, in most cases, outweigh the potential benefits. This situation could, of course, change as the years go by with the development of larger, more capital intensive farm units with a more complicated operating structure.

If you are considering incorporation, you should ask yourself the following questions:

- What is the average annual net income of your business? Is it \$40,000 plus, per operator?
- What is the future potential earning power of the business? Will you require all of the profits for personal use or can you leave a portion of the profits?
- Are there two or more active operators and will more principals be involved in the business later on?
- Do your children wish to farm and if so, how much will you want for your equity in the business? How will the transfer be funded?
- How important is the limited liability aspect of incorporation? Do you have considerable personal assets which should be protected from liability resulting from farm operations?
- What are your feelings, in general, toward a corporate structure for your farm? Would you feel comfortable working under this such a form of organization? Are you willing to trade off some possible income tax savings for higher administration costs, red tape, etc.?

In considering these questions carefully, it should help you decide whether to pursue the matter further or to drop incorporation in favor of some alternative form of business agreement. Perhaps a partnership or wage-sharing agreement would be more suitable at present. However, a farm family should not dismiss incorporation because they do not understand the technicalities involved. Some time, energy and money must be invested to get the complete picture.

Also, the farm family should periodically review its situation. The situation continually changes and although incorporation may not be the best alternative at present, it may be the ideal solution in 5 or 10 years time. It is important now for farmers to plan the future development of their business. A well thought out plan today can be a major contributing factor in the success and continuance of the farm business in the future.